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SUBJECT: SERBIAN FISCAL EXPANSION

¶1. (U) SUMMARY: Serbia's macroeconomic outlook appears strong as the country moves toward elections. GDP was up 6.7 percent in the first half of 2006, inflation likely will reach only 9 percent, and strong export growth continues, at 27 percent. Record inflows of foreign direct investment, mainly from the sale of the former Karic-owned cellular operator, have provided the Kostunica government with the resources to feed the pre-election recovery through increased public spending of 4 percent of GDP in
¶2006. However, the International Monetary Fund (IMF) raised a red flag in its recent Article IV review, warning that the pre-election binge will leave a new government a sizeable fiscal deficit, especially when real sector performance is still weak as a result of the slow pace of corporate restructuring. The possibility that the central bank governor would be replaced after the January 21 election adds to uncertainty. END SUMMARY

REAL FUTURE OR FALSE HOPE?

¶2. (U) At the moment, virtually all economic indicators paint a bullish picture of the Serbian economy. Higher GDP growth of 6.7 percent in the first half eclipsed the IMF projection of 5.7 percent. This result is especially impressive given that agricultural production was weak and the tax component of GDP underperformed.

¶3. (U) Inflation dropped to 9.3 percent (annualized rate) in October 2006, compared to price growth of 17.7 percent in 2005, but almost half of the consumer price index remains under government control. Cumulative inflation in the period January-October 2006 was 5.6 percent, and the National Bank projects that inflation on the year will not exceed 9 percent. However, the restrictive monetary policy of the NBS is only part of the story, since core inflation, although slowing, is still high at 5.8 percent.

¶4. (U) Rather, the decline of inflation has been attributed mainly to dinar appreciation, the fruit of two major policy shifts announced by the National Bank this year. In May, the Bank said it would retreat from its wholesale intervention in the exchange market and let market forces take over. This was followed by an August announcement that monetary policy was moving toward inflation targeting. On November 1, the dinar broke the support level of 80 to reach 79 per Euro, thus appreciating 13.6 percent in real terms since the beginning of 2006. Although Serbia has a history of hyperinflation, with inflationary expectations routinely factored into prices, such expectations are now easing. Dinar appreciation, external factors such as the fall of oil prices, and a GOS delay in price increases for electricity all have contributed to the inflation fall.

¶5. (U) Industrial production grew 5.5 percent in the period January to September 2006, compared to the same period last year. Yet de-seasonalized data show a fall of 2.3 percent

in September compared to August, calling into question the further trend as tighter monetary policy begins to slow activity. The service sector continues to grow with transport and financial intermediation rising over 20 percent. However, industrial production in Serbia still remains 50 percent less than 1989 levels, and unemployment hovers around 21 percent.

¶6. (U) The trade gap remains a key sustainability issue. Export growth is robust at over 27 percent, but it has not been sufficient to close the gap with imports, even in the longer-run, because of the low base and the enormous trade gap. Trade figures for the first nine months of 2006, show increased exports of 27.4 percent, i.e. 29.2 percent after Montenegro is included in the foreign trade balance. Import growth is declining, with imports up 23.9 percent year on year in the first nine months, mainly as a result of lower oil prices. The trade deficit in the first nine months of 2006 was USD 4.7 billion, 11.1 percent higher than in the same period last year. Due to the higher growth of exports relative to imports, coverage of imports by exports increased from 43 percent to 48.7 percent in the period January-September 2006.

¶7. (U) At a November 1 press conference, Governor Radovan Jelasic predicted that the current account deficit will fall to 8.6 percent, well below last year's 10.8 percent. This would be the result mainly of including Montenegro in Serbia's foreign trade balance, where Serbia is running a surplus of about 2 percent of GDP. Still, the IMF is far less optimistic and projects that the current account deficit will increase to some 12 percent of GDP, if current fiscal plans are fully implemented. The difference to some extent is based on the central bank's expectation that the effects of increased public spending will be postponed till the first quarter of 2007.

¶8. (U) Restrictive monetary policy started to bear fruit as bank borrowing from abroad remained at the same level as last year, about USD 1.6 billion for the first nine months. The growth rate of corporate borrowing also slowed, from USD 0.8 billion in first nine months of 2005 (16.7 percent in real terms) to USD 0.7 billion (10 percent in real terms) in the same period 2006. The growth of consumer lending also slowed, from USD 0.6 billion (48 percent) in the first nine months of 2005, i.e. to USD 0.8 billion (38 percent) in the same period this year. Analysts point to this lower corporate borrowing as the cause of the recent stagnation of industrial production.

¶9. (U) Responding to lower inflation and credit growth, the central bank on November 1 loosened reserve requirements on dinar deposits, from 18 to 15 percent, but the key reserve requirement on foreign bank borrowing under two years remains at 60 percent. (The high Euroization of Serbia's economy means that the dinar reserve requirement has a limited impact.) Some banks reacted by boosting the interest rate on dinar deposits, e.g., Raiffeisen bank increased interest rate from 12 to 13 percent for three months deposits and from 13 to 14 on six-month deposits (nominal interest rates). The NBS also announced a cut in the reference interest rate on two-week repo operations from 18 to 17.5 percent.

¶10. (U) Capital account inflows went through the roof mainly as a result of foreign direct investments (FDI) projected to exceed USD 4 billion this year. The headline deals included sale of the former Karic cellular operator to Norwegian company Telenor for USD 1.92 billion (of which the GOS took USD 1.4 billion, with the remainder to the Austrian co-owner who had bought out Karic.) Vojvodjanska Banka was sold to National Bank of Greece for USD 460 million, and German concern Stada acquired pharmaceutical manufacturer Hemofarm for USD 570 million.

¶11. (U) NBS foreign exchange reserves skyrocketed to USD 10 million, or about 10 months of import cover, although this stock is inflated by the central bank's tough reserve

requirements on bank borrowing abroad. Thus, the NBS's own foreign exchange reserves were USD 4.3 billion, or about 4 months of imports. (The net stock was calculated by taking total foreign exchange reserves, minus required reserve, minus the government's foreign exchange deposits with central bank). The GOS took advantage of high reserve levels to prematurely pay half of its USD 1 billion debt to the IMF. Serbia also announced plans for early repayment of USD 410 million to the World Bank by the end of 2006.

PRE-ELECTION LARGESSE FEEDS ECONOMIC GROWTH

¶12. (U) With elections now set for January 21, Finance Minister Dinkic, clearly determined to boost the prospects of his G17 party, pushed through a budget revision in September that substantially increased spending by relying on one-time revenues. Parliament adopted an amended budget for 2006 that projects an increase of current spending by 3.8 percent, but also introduces an ambitious National Investment Plan (NIP) that would add capital spending equal to 4 percent of GDP in 2006. The NIP is a two-year public investment plan, financed from privatization revenues.

¶13. (U) The amended wage bill of the central government would increase by 6.8 percent relative to the original 2006 budget. Thus, in 2006, in nominal terms, young employees in government administration will get wage increase of 62 percent, employees in the health sector will get 48 percent, in higher education, 32 percent, in the Ministry of Interior, 27 percent and in the Army, 20 percent. Dinkic also addressed the senior vote by announcing a decision to repay by the end of 2006 pension arrears from 1990s of 1.5 percent of GDP. NBS Governor Jelasic warned that all these measures will intensify pressure on domestic demand and inflation, as well as widen the trade deficit.

¶14. (U) The IMF calculates that the revised budget will result in a 2006 fiscal deficit of 0.6 of GDP, compared to the targeted surplus of 2.7 percent agreed with the IMF as part of the Extended Arrangement that ended in February. The Fund said that the deficit would be 1.4 percent of GDP if the GOS were able to spend the money as projected, but it regards this as unlikely. The Fund predicts that the impact of current policies - including tax cuts and generous public sector wage increases - could result in a general government deficit of 3.5 percent of GDP for 2007, and up to 6.5 percent if the GOS is able to implement fully spending under the National Investment Plan. The Fund predicts that this fiscal largesse will complicate disinflation, increase the current account deficit and compromise competitiveness and medium-term growth.

¶15. (U) Still, finance minister Dinkic considers the budget sustainable, despite the fact that VAT revenues are below planned levels for 2005 by about 5 percent, or a shortfall of 3 percent of total budget revenues. One-off revenues from the sale of the mobile license will be used to finance current spending. (Austrian cellular provider Mobikom was the only bidder for the third mobile license, at a minimum bid of Euro 320 million).

¶16. (U) Local experts have joined the IMF in criticizing the National Investment Plan. All agree that the state is not an efficient investor, with low project quality and poor monitoring of implementation, and emphasize that NIP spending will crowd out private investment in the short-run. Prominent economist Stojan Stamenkovic estimated that NIP implementation would imply the rise of public investment to one third of total investment, which would cause a proportional reduction of private consumption. Instead, local economists suggest that excess privatization proceeds should be invested in further reduction of public debt, reform of the pension system and tax relief.

CORPORATE RESTRUCTURING LAGS

¶17. (U) The IMF statement pointed to continuing corporate sector losses, "largely reflecting weak governance and soft

budget constraints," as the source of Serbia's continuing external deficits. The chairman's statement at the Article IV review renewed the call to sell remaining socially-owned enterprises and consistently initiate bankruptcy.

¶18. (U) However, despite lip service to the policy of "two strikes and you're out," the Agency for Privatization continues to regard bankruptcy as the policy of last resort. At an October 24 meeting with econ chief, an assistant minister of economy revealed that the GOS intends to pursue a "third way" of privatizing insolvent enterprises that have not found a buyer after two attempts at privatization via tender or auction, by selling assets selectively. While he said that some 236 socially-owned enterprises would be sent to bankruptcy, in addition the 346 in bankruptcy already supervised by the privatization agency, this means that the GOS still must deal with some 600 of the remaining 850 enterprises.

New Central Bank Governor?

¶19. (SBU) The uncertainty regarding economic policy following the election was compounded when NBS Governor Jelasic complained publicly on November 10 that the just-passed law implementing the Constitution would subject his job to political horse-trading. The law says simply that the new Parliament will name a new governor, although Jelasic began his five-year term only in February, 2004. Comments by several party officials indicated that they indeed regard the governor's position as one subject to a future coalition agreement, despite the five-year term written into the central bank law to preserve independence. We intend to point out the folly of such political manipulation with a key, supposedly independent, economic policy position.

COMMENT

¶20. (SBU) Comment: Now former Finance Minister Dinkic demonstrated once again a single-minded dedication to the immediate political objective by abandoning fiscal targets agreed with the IMF and embarking on a highly politicized relaxation of fiscal policy as elections loom. This policy will reverse the hard-won shrinkage of the public sector and leave the next government facing austerity to avoid even larger deficits. Dinkic also did not engage on corporate restructuring, leaving this crucial area to Economy Minister Bubalo, whose focus on reform sometimes seems more rhetorical than real. The result is, at best, a pronounced pause on economic reform. One way out of this hiatus would be renewed engagement with the IMF and the World Bank after elections, but such re-engagement would be problematic after the manner in which the GOS abandoned its previous commitments on reform. Under any circumstances, such a move is not even possible until a new government is formed after the January election.

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